

White Paper

Category: Fund Structure

Issue: SRF Perpetuity and Interest Rates

Background:

The Washington State Water Pollution Control Revolving Loan Fund Program (“SRF”) provides low-interest financing to local governments for projects that improve and protect the State’s water quality. The United States Congress established the SRF loan program as part of the Clean Water Act Amendments of 1987. The amendments authorized EPA to offer yearly capitalization grants to states for establishing loan programs. In addition, the amendments also require that the SRF fund be maintained in perpetuity through charging interest rates that are not detrimental to the long-term health of the Fund.

Interest Rates and Terms by State Rule and Federal Statute

The Clean Water Act states that SRF loans will be made at or below market interest rates at terms not to exceed 20 years. The Act does not define the market rate. A general market rate used by various states is the average tax-exempt municipal bond market. Title VI of the Clean Water Act USC Sec. 1383 . Water Pollution Control Revolving Funds.

SRF loan terms and interest rates are set according to state rule—Chapter 173-98 WAC, Uses and Limitations of the Water Pollution Control Revolving Fund:

Loan terms up to 5 years:	30% of average municipal bond rate
Loan terms between 5 and 20 years:	60% of average municipal bond rate
Hardship terms up to 20 years:	0% (can be as low as)

During the first ten years of the SRF program interest rates varied from as high as 5 percent for a 20 year term to as low as zero percent for a 5 year term. In State FY 2000, more than half of the SRF portfolio consisted of loans with interest rates as high as 4 to 5 percent.

In State FY 2001, Ecology decided to lower SRF loan interest rates, as allowed by rule, to 0.5 percent for loans up to 5 years and 1.5 percent for loans from 5 to 20 years. The lower rates had a positive impact on the water quality of the State as well as the fiscal health of small financially disadvantaged communities struggling to fund critical water quality improvement/protection projects. The lower interest rates also had a negative impact on the perpetuity of the SRF.

In part, the negative impact of lower interest rates on the SRF was due to market conditions such as the declining trend of interest rates in the national municipal bond market index. This declining trend began in 2001, and by June of 2005, it reached its lowest level in recent history.

The response to the declining bond market, many of the SRF loan recipients with the higher interest rates refinanced their SRF loans in favor of the lower interest rates offered on the bond market.

Consequently, a substantial amount of the SRF loan portfolio was recycled and loaned out again, but this time at the much lower interest rate of 0.5 to 1.5 of a percent.

In 2005, Ecology contracted with A. Dashen & Associates to conduct a study on the interest rates in relation to the long-term health of the fund. The resulting study (June 30, 2005) concluded that the interest rates are too low to maintain perpetuity of the fund. The study includes the assumption that perpetuity is based on a commonly used inflation index, such as the Implicit Price Deflator (IPD).

Ecology's management made the decision to raise the interest rates on SRF loans to the maximum ceiling allowed by state rule. However, the interest rate ceiling amount allowed in rule is below the recommended inflation-based interest rate in the A. Dashen & Associate study.

Cons of raising interest rates:

- The buying power of the SRF will continue to decline. This will result in result in fewer high priority water quality projects being funded in the future.
- Ecology may not be in compliance with the Clean Water Act requiring Fund perpetuity
- Loan will be less affordable to loan recipients

Pros of raising interest rates:

- Increased buying power of the fund
- Ecology will be in compliance with the Clean Water Act
- There will be more money available to fund high-priority water quality projects

Recommendations:

Update the current rule language to allow Ecology to adjust interest rates for SRF loans, while still providing competitive, low-interest loans that are consistent with Clean Water Act requirements.

Interest rate studies conducted by Alan Dashen & Associates will be considered, which may include the used of the Implicit Price Deflator or other interest rate indices as approved by Ecology's management.

Perpetuity could be defined as charging an interest rate that will result in the SRF portfolio earning 50% of the market rate. This could occur over a period of time that may be 3, 5, or 10 years depending on a market analysis.

Refinance projects may be charged an interest rate at 60% of the market rate.

Hardship considerations should not be given to refinance projects.